Gruber Chapter 25 - Fundamental Tax Reform

Tax Reform Act (TRA) of 1986 reduced the number of brackets from 15 to three. Before TRA 1986 there was accelerated depreciation, investment tax credit, special treatment of capital gains, deductions for contributions to IRAs and a variety of tax shelter opportunities. TRA 86 treated realized capital gains as regular income, limited IRA deductions, stopped the investment tax credit and reduced opportunities for tax shelter.

Changes were again introduced in 1993, 1997, 2001, 2003. Now we have 6 tax brackets, and more chances to avoid or evade taxes. Three arguments for moving to a low-rate, broad-based system: compliance, simplicity and efficiency.

Tax compliance is willingness of individuals/ corporations to pay their taxes. Tax evasion is illegal nonpayment of taxes. Tax avoidance is legal activity to shift income from taxable to nontaxable forms. Having a business lunch instead of a private lunch to claim the lunch as a deduction is tax avoidance. Not paying taxes or not reporting income is tax evasion.

Tax evasion is especially common among those who are paid in cash - harder for IRS to trace.

The benefits of evading taxes are the avoided tax payments. The costs are the risk of getting caught in the penalty to be paid if caught (see graph). At a marginal tax rate of 50%, the marginal benefit of not reporting any dollar is 0.50. The marginal cost of evasion rises with the amount of unreported income, as penalties get increasingly more severe with unreported income. The optimal amount of tax evasion is at the intersection of the marginal cost and marginal benefit curves. When the marginal cost of unreported income curve shifts up, the optimal amount of evasion falls. When the marginal benefit (marginal tax rate) shifts up, the optimal amount of evasion increases.

Evidence on tax evasion. The most recent estimate of the "tax gap" between taxes owed and taxes paid is $280 billion in 2003, 16.3% of tax revenue in that year. In developing countries it tends to be bigger - Philippines loses 73% of individual income tax revenue and 40% of corporate income tax revenue in this way. As Moldova began the transition to a free-market economy, evasion rate jumped from 5% in 1994 to 35% of revenues in 1998.

Clotfelder (1983) found that noncompliance is correlated with the tax rate. Slemrod, Blumenthal and Christian did an experiment where they sent letters randomly to Minnesotans before tax returns were due threatening to audit them. The audit threats increased reported income for lower- and middle class families, but lowered reported income for upper-class families.

Why does tax evasion matter? The same amount of revenue could be collected in a system with high tax rates and high evasion as in a system with low tax rates and low evasion. But there is an efficiency problem. When tax rate is
raised, inefficiency due to the tax increases at an increasing rate. Efficiency is increased by broadening the tax base and lowering the tax rate.

There is also a vertical equity argument against allowing tax evasion - wealthy have greater ability to evade taxes than less wealthy. Much of the wealthy people’s income comes in forms not directly reported to the IRS. Most income taxes owed by lower-income people are withheld directly from their paycheck. Cheating is likely to be more prevalent among the rich so it is not vertically equitable.

It is also a violation of horizontal equity. Two similar people in every other way will pay different amounts of tax if one is honest and the other is not.

Making the tax code simpler

A study estimated that in 2000 taxpayers in the US spent a total of 3.2 billion hours and $18.8 billion filling out tax forms, an average of 25.5 hours and $149 per person.

But making the tax code simpler could conflict with other government goals. Should the employer-provided health insurance be included in the tax base? From a Haig-Simons point of view, it should be. It would increase horizontal equity. Also by taxing health insurance, the tax base would be broader and a lower rate could be applied. But including health insurance in the tax base would make filing taxes a lot more complicated. Employers would have to report to the government and to their employees how much they contributed to health insurance each year on employees’ behalf. It would get even more complicated if the tax exclusion was capped, as employers and employees would have to figure out how to pay taxes on spending above the capped level.

Improving tax efficiency

To determine how much a tax will reduce efficiency, you have to account for all the potential behavioral changes that will come about due to the tax. Many ideas for fundamental reform, like the flat tax proposed by Steve Forbes, are motivated by the idea of reducing these distortions in how much people work, save or take risks.

How much does changing the tax rate change revenues? The tax rate affects revenues in five ways.

1. Direct effect - a higher tax rate increases revenues from a fixed tax base.

2. Indirect effects  
   a. Gross income effect - a higher tax rate tends to reduce gross income by reducing the amount of labor supplied, the amount of savings, or the amount of entrepreneurship (through the substitution effect).
   
   b. Reporting effect - Given a level of gross income, a higher tax rate will cause people to shift income to forms that are not subject to an income tax. Suppose your employer offers you the choice between a raise of $5000 and an additional
health insurance benefit that will be paid by the employer and shielded from tax, worth $3000. If your tax rate is 25% you choose the $5000 raise and pay $1250 in tax. If your tax rate is 50%, you choose the health insurance and pay no additional tax. By raising the tax rate, the government has lost $1250 in revenues.

c. Income exclusion effect - For a given amount of reported income, a higher tax rate will cause people to spend in ways that take advantage of exclusions and deduction - give more to charity, choose a bigger mortgage (Explain!) or contribute more to tax-preferred retirement savings.

d. Compliance effect - higher tax rates may reduce revenues through more evasion.

So the indirect effects offset the direct effect of more tax revenue.

Example. Suppose Bob earns $45,000 in wages per year and $5000 in cash from mowing his neighbors’ lawns. Initially there is a flat tax of 10% on income so Bob pays $5000 a year in taxes. Then the government raises taxes to a flat tax of 20%. The direct effect would be to raise tax revenue from Bob to $10,000. But Bob offsets this direct effect with indirect responses that lower his tax base.

a. He reduces work hours so wage income drops to $40,000.
b. He asks his employer to switch $2500 of his salary into health benefits.
c. He contributes $2500 more to charity.
d. He stops reporting his $5000 in lawn-mowing income.

The tax base is now $35,000 rather than $50,000. The government gets $7000 in tax revenues from Bob. Doubling the tax rate increased tax revenues only by 40% rather than by 100%.

Evidence on revenue consequences of higher tax rates.

A medium estimate is that there is a 4% decrease in taxable income base for every 10% rise in tax rates. This implies significant deadweight loss from income taxation.

Most of this effect comes from the effects of reporting, income exclusion and compliance rather than reducing gross income. Taxation doesn’t seem to have much effect on gross income. It has much more effect on what form the income is received in, on the use of deductions and exclusions, and on compliance.

This suggests that it is not just a higher tax rate but also the lack of a Haig-Simons base that causes inefficiency. If taxes were computed from a Haig-Simons base of total income (Haig-Simons base is an individual’s total annual consumption plus any increases in stock of wealth) then the tax base would respond much less to changes in the tax rate.

Most or all of the response comes from the rich. Others have little ability to shift income to different forms, as their taxes are withheld from wage payments.
Politics and economics of tax reform

TRA 86 moved the US toward a broad-based, low rate tax system. But later tax reforms moved in the opposite direction. In 1993, Clinton and Congress increased top tax rates from 31% to 39.6%, made 5 rather than 3 brackets. In 1997 Taxpayer Relief Act gave new credits for having children, educational expenses and business research. Tax code continued to get more complicated with reforms in 2001 and 2003.

Political and economic reasons for tax code to get more complicated and to deviate from Haig-Simons definition. Political reason: Political pressure for policy changes is strongest when there is a concentrated set of winners from the change who are organized and have a lot to gain. The reduction and repeal of the estate tax, for example, would affect only 50,000 households, but would save them 30 billion a year.

A strong reason for tax code complications is that politicians seem to think voters will be opposed to new government spending programs, but support the same goal when financed by a tax expenditure, despite the same implications for the budget. Clinton promised to spend on investments such as education and job training when he came into office, but ended up doing these through targeted tax cuts (for spending on college education). This tendency makes the tax code more complicated.

Economic pressures against broadening the tax base. Tax shelters.

Tax shelters are activities whose only purpose is minimizing tax payments. By the mid-1980s there were many ways to do this legally. Especially popular was finding an asset that received favorable tax treatment and using it.

Investors in real estate could deduct depreciation expenses rapidly and treat profits as capital gains. 60% of capital gains were tax-exempt. Drilling for oil and gas had 60% to 80% of the initial investment as a tax deduction.

These measures were intended by Congress to increase investment in the real estate and oil industries. But due to the tax incentives there was overinvestment.

One could get $2 of write offs for every $1 of investment in real estate. In the mid 1980s $10 billion a year was being invested in such shelters, half in real estate. Some tax shelters made losses but they were turned into profits due to the tax code.

Example: In 1983 Josh had $250,000 in income, so he was in the 50% tax bracket. He invests $100,000 in an oil-drilling venture that yielded no income and was sold for $90,000 a year later, for a loss of $10,000.

But the deduction for oil investments allowed Josh to deduct 60% of the initial investment from his 1983 taxes. At the marginal tax rate of 50% he saved $30,000. Then he could offset the $10,000 loss against other income in 1984, getting additional savings of 5000 at the 50% tax rate. So from an investment of 100,000 he obtained 125,000, a return of 25% in a year.
Transitional inequities.

Having tax shelters counters the benefits of fundamental tax reform. They make tax evasion easier, they make the tax code more complicated and they make the tax code less efficient. But an attempt to eliminate tax shelters raises a difficult economic issue: Tax capitalization is the change in asset prices due to a change in the tax on a stream of returns from that asset. Since tax shelter benefits are capitalized into the value of assets, ending such shelters would greatly decrease the values of the assets, causing horizontal inequity in the following sense.

Suppose two apartment buildings are for sale in a city. The first is in a low-income neighborhood and the second is in a richer neighborhood. The first is worth $100,000 - owners can’t charge enough rent to cover the costs. The second is worth $200,000.

Suppose a tax provision is introduced that allows people who invest in apartment buildings in low-income neighborhoods to take large tax deductions (either accelerated depreciation or an investment tax credit). The market value of the building rises to $200,000 because of this, as the stream of tax benefits is valued at $100,000. One person buys the low-income apartment building for $200,000. Another person buys the second apartment building for $200,000.

But a year later the government closes the tax shelter for apartment buildings in poor neighborhoods. The value of that apartment falls back down to $100,000. This loss is an example of how market responses to tax reform can cause transitional inequities: Changes in the treatment of similar individuals who made different economic decisions in the past and are thus treated differently by the tax reform. This is a kind of horizontal inequity.

Any tax reform will create some transitional inequity. Concerns about this led to compensation through the political process, such as grandfathering - those who made decisions under the old rules are allowed to continue to benefit from the old rules, but the rules are changed for all future decisions made. Under this system, the buyer of the low-income apartment would be allowed to keep his tax breaks, but new investors in apartments would not be able to get tax breaks.